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The Improvement of Investor Protection

Manuel F. Cohen
Chairman, Securities and Exchange Commission

I propose to discuss some of our activities which may be of special interest to you, studies that we have made or are making, proposals for new legislation or for changes in our rules, and, of course, our interest in the problems and progress of the accounting profession in its efforts to improve the standards of accounting and of financial reporting.

Pending Legislation

In the area of legislation, Senator Harrison Williams has introduced a bill which would require persons making cash tender offers for the stock of publicly-held companies to disclose their identity and background as well as other information necessary to enable shareholders to make informed decisions. In recent years, cash tender offers have become an increasingly popular technique for acquiring a controlling interest in a company. They have increased from an aggregate annual rate of about 200 million dollars in 1960 to almost a billion dollars in 1965. Shareholders faced with the necessity of deciding whether or not to accept these offers are often unable to obtain the basic information necessary to an informed decision. In supporting this bill, the Commission has proposed modifications which we feel would provide more effective protection for shareholders but would not hamper the use of the tender offer as a means of effecting changes in corporate control.

This bill would also provide the Commission with more specific authority in a related area—the repurchase by a company of its own outstanding securities. These purchases, whether by tender offer or in the open market, can, like tender offers, have a significant effect both on the market price of the securities and on the control of the corporation.

Another bill pending before Congress, which we endorse, is designed to assure full disclosure in interstate public offerings of lots in unimproved subdivisions. These disclosure requirements would be implemented by a registration procedure, administered by the SEC, comparable in form to that provided in the Securities Act of 1933. (We tried to interest other agencies in administering this law, but they all assured the Congress that the SEC was best equipped to handle it.) This legislation would afford important protection to many people of limited means who are interested in purchasing home sites for retirement or vacation purposes.

We also have a substantial interest in a proposal to amend the Welfare and Pension Plan Disclosure Act, because of the remarkable growth of these plans and their actual and potential effects on the securities markets. During the fifteen years ending in 1965, the stockholdings of noninsured pension funds increased in value from about one billion to forty billion dollars. Recent projections of private pension fund assets indicate that they will double within the next decade. These pension plans, like other institutional investors, are characterized by the fact that a small group of managers makes the investment decisions for a large group of indirect investors. Yet in many cases, the managers of these plans are not subject to any effective legal controls—many are not even subject to state laws governing the conduct and fixing the obligations of trustees. I am sure you will be interested in the fact that, in addition to a provision intended to remedy this defect by establishing a federal fiduciary obligation, one of the key protections provided in the proposed amendments is a requirement for the filing of annual financial statements certified by independent accountants.

We have also made recommendations to Congress for important changes in the Investment Company Act of 1940 to provide additional protection for the more than 3½ million people who have invested in securities through the medium of mutual funds.

These recommendations have their origin in Section 14(b) of that Act, which authorized the Commission to make a report and recommendations to the Congress whenever it deemed that substantial increase in the size of investment companies created any problem involving the protection of investors or the public interest. Pursuant to that authorization, the Commission in 1958 directed the Wharton School of the University of Pennsylvania to study certain practices and relationships in the industry. The Wharton School report was submitted to Congress in 1962. It was supplemented by the publication in 1962-63 of the report of the staff of the Commission's Special Study of the

Securities Markets, one chapter of which explored sales practices in the mutual fund field, problems created by the front-end load in the sale of contractual plans and by allocation of mutual fund portfolio brokerage. Neither of these reports was a report of the Commission. The Commission made a comprehensive study to evaluate the public policy questions raised in these reports and, in December 1966, it submitted its own report to Congress. The principal amendments, or at the least those which have stirred up some controversy, would provide:

(1) That all compensation received by persons affiliated with an investment company must be reasonable.
(2) That the statute provide that sales charges for investment company shares be fixed at 5 per cent with some flexibility in the Commission to increase that charge where appropriate.
(3) That the so-called "front-end load" sales charge be prohibited.

These recommendations are embodied in a bill which we sent to the Congress on May 1, 1967. I do not plan to discuss with you in detail our proposals and the reasons which underlie them, but I do want to say that we consider these reforms to be essential to the continued well-being, not only of the mutual fund business, but of the securities markets generally.

Finally, in the area of legislative proposals, we support the pending proposal of the Federal Reserve Board that the Board be empowered to adopt rules, similar to those which apply to listed securities, authorizing and limiting the extension of credit by brokers and dealers in connection with transactions in securities which are not listed on any exchange but are widely traded in the over-the-counter market.

Disclosure Requirements

We are currently exploring alternative methods of upgrading the quality of disclosure in reports filed under the Securities Exchange Act of 1934 and at the same time simplifying, where appropriate, the requirements for registration under the Securities Act of 1933 by issuers whose securities are also registered under the 1934 Act. When a company registers securities under the 1933 Act, the material facts about the company are presented in an organized and unified way in the registration statement and prospectus, and the disclosure provided in this way is of high quality. Since disclosures of material facts under the reporting requirements of the 1934 Act are not made all at once but are made periodically in annual or other reports, proxy statements and other documents, problems are presented to investors, their advisers, or even broker-dealers and other professionals, who are seeking complete and up-to-date information about a company in readily available form. We believe the 1934 Act disclosure requirements can be improved without imposing undue burdens on reporting companies. To the extent that complete and up-to-date information is publicly available through material filed under the 1934 Act, it may be possible to reduce the amount of information required in a 1933 Act registration statement without sacrificing any of the important protections which the 1933 Act is designed to afford.

As a part of this general effort, the Commission recently proposed a new short form for registration of certain equity securities under the 1933 Act. In proposing a reduction of disclosure requirements we must proceed with caution to make sure that we preserve for investors, their advisers and the securities industry the important benefits provided by the registration and prospectus requirements of the Act.

We therefore proposed to limit the use of the new short registration form to companies of established size, with stable operations and earnings, concerning which we could reasonably expect that information omitted from the registration statement and prospectus would otherwise be readily available. We suggested four basic limitations on the use of the form, which we do not believe are unduly restrictive and which we believe are consistent with this premise. It is estimated that 400 to 500 companies would be eligible to use the form.

We have proposed that the form be available only for companies with securities listed on a national securities exchange. While other facets of the proposal have also been the subjects of criticism, I would like to offer a word of explanation for this particular limitation on the use of the proposed form. Although the 1964 Securities Act amendments extended the 1934 Act disclosure requirements to many unlisted companies, the rules of the principal stock exchanges require, in many respects, more complete and up-to-date disclosure than is elicited by the disclosure requirements of the 1934 Act, and we believe this additional disclosure is an important factor in the decision whether and the extent to which the proposed short form should be available.

As I said, we have received a great many comments on the proposed short form, suggesting possible alternative formulas for use of the form. We are giving very careful attention to these suggestions, and hope to make

rapid progress on this matter.

Of course, the great bulk of securities transactions takes place in secondary trading to which requirements of the 1933 Act are inapplicable. Improvement of the 1934 Act disclosure requirements is essential wholly apart from the possibility that this may provide a key to modification of the disclosure requirements under the 1933 Act. We have proposed and are presently considering other modifications of the rules and forms under the 1934 Act to assure that adequate information about all publicly held companies is available to investors and others in current and understandable form.

As a result of the 1964 amendments, all domestic companies which have assets in excess of $1,000,000 and more than 500 stockholders must now meet the full range of registration, reporting and other requirements of the 1934 Act. This almost doubled the number of companies subject to these reporting requirements to a total of almost 7,000. Thus any improvements in disclosure that can be accomplished will have a far greater impact than if they applied only to listed companies.

You may recall that in 1964 we also changed certain of our proxy rules to require, among other things, that any material differences in the financial statements included in the annual reports filed with us and the data included in the annual reports to shareholders be reconciled or explained in these latter reports. This has had a salutary effect on financial reporting to investors. Recently we amended the rules further to require that comparative statements for the last two fiscal years be provided in the annual reports to shareholders so that the investor will have a better basis for appraising the progress of a company.

Accounting Principles and Practices

The current efforts of the accounting profession to develop accounting principles and to narrow the range of unwarranted differences in accounting practices are of great importance to us. While the various securities laws give the Commission authority to prescribe standards, the Commission as a matter of policy has always preferred to encourage the profession to take the initiative in the development of improved financial reporting practices.

Much progress has been made by the profession since the inception of the Commission, but, I am happy to say, the pace has increased in recent years. Attention was focused on the problem in the Congressional hearings on the 1964 amendments to the securities acts. In those hearings the Chairman of the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce requested my predecessor to file a statement for the record setting forth areas of accounting where alternative practices could produce materially different results under generally accepted accounting principles.

We submitted a memorandum to Congress discussing variations in practice in eight important areas: valuation of inventories; depreciation and depletion; income tax allocation; pensions; research and development costs; goodwill; when income is realized; and "all-inclusive" versus "current operating performance" income statements. We also referred, without discussion, to other topics: intercorporate investments, long-term leases, principles of consolidation, business combinations, income measurement in finance and small loan companies, and intangible costs in the oil and gas industry. While this is a lengthy list, it was not intended to be a complete list of all areas where alternative accounting methods are acceptable, or even all those in which the alternative methods can produce materially different results.

I am pleased to note that since the time we submitted that memorandum (which was subsequently published in the June 1964 issue of the Journal of Accountancy), the American Institute of Certified Public Accountants has taken a number of noteworthy actions leading toward the improvement of accounting and reporting practices. In October, 1964, it issued a special bulletin requiring its members to disclose any departures from opinions of the Accounting Principles Board (as well as effective Accounting Research Bulletins issued by the former Committee on Accounting Procedure). This was intended to emphasize the authoritative character of the Board's opinions and to hasten the narrowing of areas of difference in the application of generally accepted accounting principles. The Council also specified that the Board review existing bulletins and opinions issued before December 31, 1965, to determine whether any of them should be revised or withdrawn. This review, the results of which were published as APB Opinion No. 6,

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was a further aid in the narrowing of unjustified alternative practices.

In 1966, the Accounting Principles Board issued three significant opinions, one dealing with pension plans, one on reporting the results of operations, and one omnibus opinion dealing with a number of areas in which greater uniformity of practices is desirable. I understand that the APB has research studies under way on many of the other areas cited in the memorandum. With the accelerated pace at which the APB is now functioning, I am hopeful that opinions will be issued in the not too distant future on some of the other problem areas such as, to name a few, income tax allocation, research and development costs, goodwill, intercorporate investments, principles of consolidation and business combinations.

Conglomerates

A comparatively new problem area in accounting and financial reporting is the need for more informative reporting on the operations of so-called "conglomerate" companies —those widely diversified companies whose operations include a number of distinct lines of business or classes of products or services. This problem has become more significant as a result of the increasing numbers of acquisitions and mergers in recent years, many of which involve companies in different and unrelated lines of business. Some examples that we have noted recently include a diversified electronics manufacturer acquiring an auto rental organization, a tobacco company acquiring a distillery, a food and dairy products processor acquiring a furniture maker. Then, of course, there are the avowed conglomerates, such as Litton Industries and Gulf and Western Industries, which have acquired companies in a large number of different fields. In all of these cases the problem is the same— where investors formerly had separate financial statements on the different operations, they may now receive statements which give very little meaningful information about how the conglomerate company derives its income. This not only makes it more difficult for investors to make informed decisions and comparisons of different companies; it also makes it more difficult for stockholders to judge how well their management is performing in the various areas of operation it has chosen to enter.

I have indicated on several occasions that we consider this problem to be of the utmost urgency, and a recent article in Dun's Review indicates that this opinion is shared by many responsible leaders of the financial and business communities.

In determining what additional information conglomerate companies can practicably provide about their diversified operations, a number of matters must be considered, including the amount and type of additional disclosure that will be most meaningful.

In this connection, as I have said before, experience may prove to be the best guide, and the breakdowns which are being voluntarily furnished by an increasing number of conglomerate companies should be very helpful to us and to other interested groups in formulating definitive standards. I am pleased to be able to report that our preliminary review of 1966 annual reports to stockholders indicates that some significant progress is being made. A survey of the reports of 241 large companies for 1965 and 1966 shows that the percentage showing a breakdown of gross revenues by product line increased from about 37% in 1965 to about 51% in 1966. This increase, accounted for by 39 companies which include breakdowns of sales for the first time in 1966, was offset, I regret to note, by seven companies which furnished such a breakdown in 1965 but not in 1966.

In the area of net income, 24 of 331 companies whose 1966 reports were reviewed provided substantial disclosure concerning the relative profit contributions of their different product lines or divisions. (In evaluating this figure, it should be kept in mind, first, that very few of the 24 companies had provided any comparable disclosure in 1965 and, second, that the sample of 331 companies includes many that could probably not be classed as conglomerates under any definition.) These disclosures appeared to fall into three different patterns: those which showed relative contributions to net income, those which showed relative contributions to net income before allocation of corporate overhead, taxes and other items, and those which showed the relative "operating profits" of the various divisions.

I believe that these preliminary statistics are a measure of the increasing awareness by corporate financial officers and accountants of the necessity of providing additional information, as well as of the magnitude of the job still to be done, both in terms of developing definitive standards and securing general adherence to them.

This is another area in which we are cooperating with the accounting profession, as well as other interested business and professional groups, in the consideration of the problems involved. A thorough study is being conducted by the Financial Executives Institute which should be very helpful to us in develop-

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its efficacy with the passage of Sections 1245 and 1250 of the Code as, in any event, the majority of such gains will be treated as ordinary income to the extent of post-1961 and post-1963 depreciation. There can be instances, however, where the gain is sufficient to involve capital gains income, and a recent case reveals a possible tax problem in this area.

Section 1239 (a)(2) stipulates that ordinary income will result in the case of a sale of depreciable property between an individual and a corporation in which the individual owns more than 80% in value of the outstanding stock. In *U.S.* v. *Curtis L. Parker,* (CA-5) 4/14/67 the danger of a literal interpretation of the phrase "80% in value" is emphasized.

In the Parker case, taxpayer owned 80% of the outstanding stock, and an employee owned the other 20%, with a corporate right of first refusal extending to both shareholders in the event they wished to dispose of the stock. There was also a collateral agreement between Parker and the employee that in the event of the employee leaving the firm his shares would be purchased by Parker on a set formula basis. A sale of depreciable property to the corporation by Parker was taxed as ordinary income as he was deemed to own more than *80% in value* of the outstanding stock. The Court held the fact that Parker's stock was subject to only one restriction, the corporate buy-out, and was a majority interest, made it worth more than the 80% interest indicated through actual share-holdings.

In view of this decision, in any case where the taxpayer has a majority interest, but not more than 80% of the outstanding stock, and hopes to circumvent Section 1239, he must be prepared to have the value of his holdings challenged on the basis of the true value of a majority interest.

Depreciation Methods

Certain accelerated methods of depreciation, such as double declining balance and sum of the years-digits method, are available to taxpayers in the case of property with a useful life of at least three years if the *original use* of such property commences with the taxpayer. Great care should be exercised in the adoption of these methods to see that the property is qualified property. Based on Revenue Ruling 67-50, in the event an accelerated method is improperly applied, as for example in the case of used property, the adjustment made on examination will be to the straight line method only. In other words, the 150% declining balance method which could have been elected by the taxpayer upon acquisition of the used property will not then be allowed by the Treasury Department.

D.L.B.

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ing guidelines or rules to achieve more informative financial reporting by the diversified company. The American Institute of Certified Public Accountants and other interested organizations are also cooperating in this endeavor.

Conclusion

Much of my discussion has related to efforts by us and by the accounting profession to obtain better disclosure of financial and related information for the public. Since the financial statements provide the key information in the distribution and trading of securities, the work of the accountant in examining the financials is most important in the disclosure process. We place great reliance on the work of the independent accountants through our requirements for certified statements in almost all filings with the SEC. The accountants lend authority to management's representations by their opinions as experts, and they operate as a check on management in assuring that the financial data are fairly presented in accordance with generally accepted accounting principles.

There are many areas in which investor protection has been and can be further enhanced by utilization of the audit function of the independent accountant. You may recall that a few years ago we made changes in the reporting form used under the Investment Company Act of 1940 to require that the independent accountant, in addition to certification of the financial statements in such reports, express an opinion as to the fairness of the presentation of information required by other items of the form, such as asset coverage of senior securities and portfolio turnover rates. The accountant is also required to state, in connection with certain additional items, that he has seen nothing which indicates that the answers supplied are incorrect. We are currently considering a change in the audit requirements for brokers and dealers under Rule 17a-5 which would require the independent accountant to comment specifically on the adequacy of the accounting system, the internal control and procedures for safe-guarding securities, to identify inadequacies, and to indicate corrective actions taken or proposed to be taken.

We believe that increasing the accountant's responsibilities in these ways not only furthers our primary objective of providing investor protection, but also emphasizes our confidence in, and reliance upon, the accounting profession in a continuing joint effort by the stock exchanges, the SEC, the accounting profession, and the finanacial officers of publicly-held companies to improve financial reporting.